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Directive 86-22: Investment Interest Incurred To Purchase Property Subject To A Net Lease

Facts 1: Mr. Davis borrows \$50,000 at 10% annual interest to purchase rental property which qualifies as property subject to a net lease pursuant to section 163(d) of the Internal Revenue Code. During the taxable year, Davis incurs interest expense in the amount of \$5,000 on this investment indebtedness. Davis does not incur any other interest expense. Davis reports the investment interest expense on his Schedule E (Form 1040).

Facts 2: Mr. Evans borrows \$50,000 at 10% annual interest to purchase taxable securities for investment purposes. During the taxable year, Evans incurs interest expense in the amount of \$5,000 on this investment indebtedness. Evans reports the investment interest expense on his Schedule A (Form 1040).

Issue 1: To what extent may Davis deduct the interest expense accrued on indebtedness incurred to purchase the property subject to a net lease on his Massachusetts return?

Issue 2: To what extent may Evans deduct the interest expense accrued on indebtedness incurred to purchase the taxable securities on his Massachusetts return?

Discussion: Massachusetts law does not adopt the deductions permitted under section 163 of the Internal Revenue Code unless they are also allowed under section 62 of the Code. G.L. c. 62, § 2(d). The deductions allowed under section 62 include the deduction for expenses incurred in the production of rents and royalties whether or not such rental property is held for investment. I.R.C. §§ 62(5). Property subject to a net lease is property held for the production of rents and royalties. Therefore, the interest expense accrued on indebtedness incurred to purchase property subject to a net lease is deductible under Massachusetts law.

Property which qualifies as property subject to a net lease is investment property for purposes of section 163 of the Code. The deduction, therefore, is subject to the limitation for investment interest found in section 163(d). I.R.C. § 163(d)(4).

Interest expense accrued on indebtedness to purchase securities for investment purposes is an investment expense which is not deductible under section 62 of the Code. Therefore, this interest is not deductible under Massachusetts law.

Directive 1: Davis may deduct the investment interest incurred to acquire the property subject to a net lease. He may deduct the full \$5,000 because it is within the limitation prescribed in section 163(d). The deduction is included on both his U.S. Schedule E and his Massachusetts Schedule E.

Directive 2: Evans may not deduct the investment interest incurred to acquire the taxable securities.

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Reference: G.L. c. 62, § 2(d); I.R.C. §§ 62(5), 163.

/s/Ira A. Jackson
Ira A. Jackson
Commissioner of Revenue

20 August 1986

DOR-D 86-22

This Directive represents the official position of the Department of Revenue on the application of the law to the facts as stated. The Department and its personnel will follow this Directive, and taxpayers may rely upon it, unless it is revoked or modified pursuant to 830 CMR § 62C.01(5)(e). In applying this Directive, however, the effect of subsequent legislation, regulations, court decisions, Directives, and TIRs must be considered, and Department personnel and taxpayers may rely upon this Directive only if the facts, circumstances and issues presented in other cases are substantially the same as those set forth in this Directive.